CRS Insights

"Dark Pools" In Equity Trading: Significance and Recent Developments
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Dark pools are relatively recent and controversial electronic stock trading alternatives to traditional exchanges, such as the New York Stock Exchange (NYSE), and now account for about 15% of overall trading volume. A dark pool is a type of *alternative trading system* (ATS), a broker-dealer who matches the stock trading orders of multiple buyers and sellers outside of exchanges. Orders sent to dark pools to buy or sell certain stocks are not publicly displayed. When they emerged in the late 1990s, that opacity attracted the pools' initial clients, institutional investors (such as pension and mutual funds), who used it to conceal large trading interests, thus helping to reduce the risk of the market moving against their trades. Quote concealment is a legacy of a regulation adopted by the Securities and Exchange Commission (SEC) in 1998, Regulation ATS, which allowed ATSs with less than an average 5% share of the trading volume to not publicly display their quotes. This contrasts with the "lit" venues, Nasdaq and the exchanges, which do.

Under Regulation ATS, dark pools are required to register either as exchanges with the SEC or as broker-dealers with the Financial Industry Regulatory Authority (FINRA). FINRA, which the SEC oversees, is the frontline regulator of SEC-registered broker-dealers. Dark pools are subject to the same rules that govern trading either on an exchange or by a broker-dealer.

While large block trades of say, 1 million shares, were initially a focus of dark pool trading, in recent years, average sizes have shrunken to a few hundred shares, comparable to levels on exchanges.

Major forms of dark pools include broker-dealer-owned pools, including Credit Suisse's CrossFinder and Goldman Sachs' Sigma X; agency-broker pools, including Liquidnet and ITG Posit; and exchange-owned pools, including those operated by BATS and the NYSE.

Pros and Cons of Dark Trading

Dark pools are at the center of a contentious policy debate on their impact on securities markets and investors. Key elements are discussed below.

As described earlier, the pools' quote opacity can benefit large institutional trades. The pools are also said to give traders comparatively more autonomy in the choice of the opposing buyers and sellers, thus avoiding potentially problematic traders (i.e., those who may do forms of high frequency trading described as predatory). The pools may also benefit traders because they tend to charge relatively less for traders than do Nasdaq and the exchanges.

On the other hand, there are concerns that quote opacity prevents pools from contributing to the critical price discovery process. Consequently, it is argued that the ability of the overall securities market to equilibrate the most accurate securities prices is impaired. Summarizing the research on this, SEC chair Mary Jo White observed that the consensus appears to be that "dark trading can sometimes detract from market overall quality, including the informational efficiency of prices." She also said the agency would continue examining whether dark trading volume was approaching a level that could undermine the quality of price discovery on the lit venues.

The existence of the 40 or so dark pools has also contributed to a fragmented equities marketplace, which encompasses about 11 exchanges and some 200 broker-dealers who execute retail trades through their own stock inventory, called internalization. The fragmentation appears to have helped boost competition, which has benefited traders in areas, such as lowered trading costs and trading infrastructure innovations. But, particularly with respect to individual dark pools, it may impose multiple connectivity burdens on traders.

New York's Civil Suit Against Barclays' Dark Pool

On June 25, 2014, New York Attorney General Eric Schneiderman filed a civil suit against one of the largest dark pool operators, Barclays, under New York State law. A central allegation is that Barclays misrepresented the level of aggressive HFT activity in its dark pool to other clients, potentially undermining the integrity of such investor disclosures.

On the broader implications of the Barclays' suit, an official at Rosenblatt Securities, which conducts securities market analysis, observed, "The problem isn't that high-frequency trading firms are participating in dark pools. That's pretty widely known, it's not necessarily bad and it's happening in most of the major ones…. [The] troubling … allegation [is] that the broker lied to clients about the presence of a big HFT firm." (See the full speech.)

Recent SEC and FINRA Actions

The SEC and FINRA have both been involved in dark pool-related investigations as well as in broader regulatory efforts directed at the pools.

For example, in June 2014, media reports indicated that the SEC was investigating several large dark pools according to people with familiarity of such probes.

FINRA is reportedly seeking data on the operations of various dark pools, including what they disclose to clients, information that could be used for enforcement actions.

In addition, Credit Suisse, Deutsche Bank, and UBS, major dark pool operators, have reportedly acknowledged facing inquiries from regulators over their dark pool operations.

In May 2014, FINRA began requiring ATSs, including dark pools, to regularly release data that include the number of executed securities trades, disclosures aimed at improving transparency.

In June 2014, the SEC announced a pilot program of the so-called "trade at" rule for lightly traded stocks: Generally, trading in off-exchange venues like dark pools would be allowed if they possessed quote prices that improved on those found on lit venues. Exchanges, including the NYSE, have argued for such regulation, while broker-dealers, many of whom own dark pools, have opposed it. Both Canada and Australia have adopted system-wide trade at rules. In both instances, the volume of dark trades subsequently fell significantly. A study on the impact of the Canadian "trade at" rule also found that it led to a shift from a kind of dark trading that tends to benefit market quality to a kind that tends to reduce it.